Abiding by Reg D - Do Not Accept Non-Accredited Investors

Reference:
http://startuplawyer.com/preferred-stock/life-is-too-short-to-deal-with-non-accredited-investors

The Securities Act of 1933 provides companies with a number of exemptions from registration with the SEC. Two distinct but related exemptions, Rules 505 and 506 of Regulation D, provide that a company can sell its own securities to an unlimited amount of "accredited investors." (*Please keep in mind there are several other requirements your startup company must follow to properly obtain an exemption from registration under the securities laws*.)

The definition of an accredited investor is found in Regulation D's Rule 501 of the federal securities laws. An accredited investor is:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
- a charitable organization, corporation, or partnership with assets exceeding $5 million;
- a director, executive officer, or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase;
- a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or
- a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

In addition to accredited investors, Rule 505 and 506 permit raising capital from up to 35 *non-accredited investors* (i.e., anyone that does not fit the accredited investor definition above). But that doesn't mean your company *should* raise capital from non-accredited investors, and for a good few reasons:

(1) **Non-Accredited Investors Trigger a Larger Disclosure of Information** – If you raise capital from non-accredited investors in a Rule 505 or Rule 506 registration-exempted financing, you must provide a huge amount of information about your startup company. Think IPO-registration huge, thereby leading to larger legal and accounting costs. Such additional costs may not be prudent if your startup company is tight on capital.

(2) **Non-Accredited Investors Tend to be More Hostile Than Accredited Investors** – Implied by the definition of a non-accredited investor, the investment a non-accredited investor makes to your startup company will mean much more to him or her than an investment an accredited investor makes. A non-accredited investor will be much more emotional. Thus, non-accredited investors are much more likely to sue your company if things don't go according to plan.

(3) **Non-Accredited Investors can Hinder an Acquisition** – It may be difficult for your startup company to be acquired after it has completed a registration-exempted financing with non-accredited investors. Non-accredited investors trigger additional rules in the context of an acquisition (e.g., a purchaser's representative). Sometimes the acquiring entity will require a startup company to perform a buyout the non-accredited investors pre-acquisition.

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Therefore, if at all possible, your startup company should refrain from raising money from non-accredited investors. They simply create too many problems during and after your financing.

About the Author

Ryan Roberts is a startup lawyer and represents technology companies through all phases of the startup process, including incorporation, seed & venture financings, and exit transactions. Click here to learn more about his practice.